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SUBJECT: Stability and Growth Pact: Revived, Passes First Test

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¶1. (SBU) Summary: Even before modifications of the Stability and Growth Pact (SGP) were adopted by the Council on June 27, the European Commission (EC) had passed its first test applying the "spirit" of the new rules to Italy and Portugal. The EC's recommendations that these countries should be subject to Excessive Deficit Proceedings (EDP) is likely to be accepted by the Ecofin Council on July 12 for Italy and September or October for Portugal. Applying what popular wisdom perceived to be more lenient rules did not allow Italy, with a deficit hovering around 3.1% of GDP, to escape EDP. Portugal's deficit of 6.2% was not even a close call as the government gave up on one-off measures to reduce the deficit. A close reading of the staff reports suggests that the EC has actually tightened its economic analysis, shutting down arguments that deficits became excessive due to exceptionally prolonged low economic growth or other relevant factors like costly structural reforms or investments.

¶2. (SBU) The EC believes it has to press ahead to demonstrate that the SGP functions. The current EU political crisis might give it a bit of a tailwind as member states wish to show that EU and the Eurozone are not paralyzed. Offering countries an extra year to correct their deficits should make the new SGP prescriptions more palatable. As before, the major cases of Germany and France will demonstrate whether Finance Ministers have the political will to follow the new rules. But, for this moment, the SGP looks revived. End Summary.

New Rules Take Effect...

¶3. (SBU) Amendments to the regulations that form part of the SGP were adopted by the Council on June 27. These had been proposed by the EC in April based upon Ecofin's report to Heads of State in March on "Improving the Implementation of the Stability and Growth Pact." That report was agreed after contentious negotiations.

¶4. (SBU) As noted reftel, EC staff were principally disappointed that Ecofin's admonishment for countries to make adjustment to move their budgets to balance or close to balance in good economic times did not find their way into proposed amendments. This was particularly disappointing as Council members fought to include specific, hard fought language of the Council report to make sure their own concerns, e.g. German reunification costs, were covered. As a result of this Council editing, the text of the EC's draft amendments, which were designed to be as short as possible and suitable for legal text, became longer and less legalistic.

¶5. (SBU) European Parliament's Economic and Monetary Affairs Committee (ECON) shared the EC's view on the need for rules for adjustment during economic up-swings, but amendments to this effect were voted down by the plenary on the first reading. Undeterred, ECON reasserted its position and took it to a second reading where its proposal failed to secure the necessary majority, losing 257 to 309 on June 23. EC staff were comforted by the fact that they had allies in the Parliament, but the new regulations, as modified by the Council, were set for final approval.

¶6. (SBU) EC staff also has been working on a code of conduct that lays out the rules for application of the Pact in more detail. The Economic and Finance Committee will

discuss the EC's draft this week and the Council should endorsed it shortly thereafter.

But EC Already Applied Their Spirit .

¶7. (SBU) Even before the Council's adoption of the amendments, the EC applied the "spirit" of the modified rules in the cases of Italy and Portugal. On June 7 the EC issued an assessment of Italy's budget situation in light of Eurostat's May 23 revised figures showing Italy's deficit had been 3.1% of GDP in 2003 and 2004. On June 22 the EC issued an assessment of Portugal's budget situation in light of the new Portuguese government's updated stability program. Contrary to its predecessor, the new government does not plan to use extraordinary measures to reduce its deficit, but has pledged a gradual reduction from an estimated 6.2% in 2005 to 2.8% in 2008.

In Unexpected Ways..

¶8. (SBU) Popular wisdom has been that the modifications to the SGP would make any excessive deficit case nearly impossible to make. The deficit could be over 3% and considered exceptional and temporary if caused by adverse economic conditions like prolonged slow growth. Moreover a list of "all other relevant factors" could be cited, such as structural reforms implemented under the Lisbon Agenda or financial contributions to the EU budget, to avoid an EDP proceeding. According to this popular wisdom, the SGP was history.

¶9. (SBU) A close reading of the EC's report suggests that popular wisdom did not have it quite right. As explained by an EC expert, to initiate an EDP, first the EC assesses whether the deficit is close to 3% and whether the excess over that reference value is exceptional (due to a severe downturn or prolonged slowdown of the overall economy) and temporary. If the EC's assessment is that the deficit is not close to 3% or it is not exceptional and temporary, it can recommend the Council launch an EDP. In taking that step, the EC examines "all other relevant factors," which also include cyclical conditions, consolidation efforts in good times, and debt sustainability.

¶10. (SBU) In the case of Italy, the EC report does not comment on whether 3.1% is close to 3%. The number, however, does not leave much to the imagination. The EC report concludes that the deficit is not temporary. As noted above, Eurostat's revised numbers show a deficit of 3.1% for the last two years. The EC's spring 2005 forecast projects a deficit of 3.6% this year and 4.6% in 2006, both likely to be higher in light of Italy's slowing economic growth, according to another EC expert. The EC report observes that Italy's economic slowdown is not exceptional. Yes, Italy's growth has been slower over the last decade than before. However, EC staff point out that the slowdown reflects structural weaknesses that have reduced Italy's potential growth rate from 2.3-2.4% at the end of the 1980's to "slightly above 1.5%." While Italy has grown less than its potential for the last three years, the EC notes that this output gap is not as large as those during other economic recessions in the early 1980's and early 1990's.

¶11. (SBU) What about the "other relevant factors?" Reforms adopted in March to improve Italian competitiveness will cost less than 0.1% of GDP, according to the EC's assessment. Expenditure on R&D and education remained constant as a share of GDP and does not explain the deficit increase. The EC points out that: 1) the cyclically adjusted deficit is likely to stay around 3.9%; 2) the Italian government expanded the deficit rather than shrinking it in good economic times; 3) the deficit had been reduced by one-off measures which the government is phasing out; and 4) the government's projection of deficits were consistently lower because of overly optimistic economic growth projections. To top it off, the EC's close examination of debt dynamics show that Italy's debt to GDP of 106.5% of GDP (compared to the SGP reference value of 60%) is unlikely to be declining any time soon.

¶12. (SBU) For Portugal the story was very similar. The EC states that a deficit of 6.2% is not close to 3%, an easy call. The deficit is not temporary, under the GOP's own assumptions of not falling under 3% until 2008. And the deficit is not due to exceptional circumstances, again comparing Portugal's lower growth potential with output gaps in previous recessions rather than just looking at its recent poor economic growth. With respect to other relevant factors, the EC report gives Portugal little slack. The effect of recent structural reforms on the budget is difficult to estimate, although expenditures in education have increased continuously since the 1990's. But the cyclically adjusted budget is not set to decline and the government's reliance on one-off measures and overly

optimistic growth forecasts masked the reality that the debt stock has increased from 53.4% of GDP in 2000 to a projected 67.5% in 2006.

¶13. (SBU) One area where the modified rules appear to have made a difference is in the time to correct the deficit. Previously, the EC interpreted the SGP as requiring the deficit to be corrected a year after its identification. The EC will recommend that Italy be given until 2007 rather than 2006 and Portugal to 2008 (on the assumption that the 2005 budget will be the first year over 3%), in line with the government's program. A senior EC official reported that his was hotly debated within the EC. Those favoring strict adherence to the old interpretation argued that crisis budgets are more successful when the reductions are front-loaded rather than explaining painful adjustments year after year. The other view was that an extra year took better account of the politics of national budget cycles and is a "bargaining chip" for the countries to accept EDP. The latter won.

¶14. (SBU) An EC expert explained that the modified rules provided an opportunity for the EC to change its presentations to give a more economically robust justification for recommending an EDP. The presentations for both countries adhere to the same format and systematically run through all the economic arguments that had been included in the Ecofin report. The EC gives consideration to "all other relevant factors," then puts them aside as they did not cause the deficit to become excessive. As a result, countries have a more difficult time rebutting the EC case.

¶15. (SBU) According to a senior EC official, the Economic and Finance Committees showed little sympathy when the Italians started to explain away their excessive deficit. The EC's analysis had graphically shown how shoddy statistical governance and a series of one-off measures were used to hold the deficit under 3%. Most member state representatives were "fed up," accord to this official.

¶16. (SBU) Most member states have not appreciated that the EC will rarely find an excessive deficit to be temporary, according to an EC expert. When the EC makes budget projections, it does so on the basis of no policy changes. That is, unless there are policy changes, the deficit will almost never be considered temporary.

¶17. (SBU) Slow growth may be cited as a justification for running slightly larger deficits. But there is a question as to how slow growth should be defined. Basing slow growth on the output gap was discussed early on by EC staff and included in the Council's report. This point is that a country could claim a prolonged economic slowdown, but if prolonged for a sufficient time, growth potential drops making a return to higher growth problematic and economic forecasts based on the good old days overly optimistic.

But Germany and France Will Be Real Tests Again.
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¶18. (SBU) The EC's recommendation that Italy be subject to an EDP was adopted by the full Commission June 29th and sent to Ecofin for its endorsement at its July 12th meeting. Since the Economic and Finance Committee accepted the EC's report, EC staff are confident Ecofin will agree. The recommendation on Portugal will be considered by the Economic and Finance Committee this week. On July 12 Ecofin will hear a report on the GOP's updated stability program, but will not act on the EC's recommendation until its meeting in September (unlikely as it is an informal meeting) or October.

¶19. (SBU) The EC is already preparing for the next cases on Germany and France. German Finance Minister Eichel has admitted to Commissioner Alumnia that the deficit will be over 3% in 2005 and likely again in 2006. EC staff reckons it will be around 3.5% this year. France's announcement of job creation measures and tax cuts do not bode well for a deficit that is skirting 3%.

¶20. (SBU) The EC could start action on either country at any time, but the most likely opportunities will be after the September 1 notification of likely budget outcomes or the EC's autumn forecast due out November 12. As Germany is likely to have a national election in mid-September, EC staff believes the German notification due on September 1 will be delayed.

¶21. (SBU) Since Germany and France are already in EDP the issue will be whether Ecofin should escalate proceedings to 104(9), the last step before sanctions, or repeat a recommendation under 104(7). Under the modified SGP rules, a recommendation under 104(7) can be repeated provided unexpected economic factors had caused the deficit not to decline as projected even though the government had taken

effective action in line with the initial recommendation. The economic outturn is compared to what the EC had projected for growth and the deficit.

¶22. (SBU) In the assessment of a senior EC official, both countries may experience weaker growth than initially forecast. He believes that Germany could make a case that it has taken effective actions, but, in his view, France could not. While he recalled that France was willing to accept a recommendation under 104 (9) in November 2003, times have changed, and he is not so sure that they would do so this time.

Comment

¶23. (SBU) EC staff have surprised themselves with their more robust economic analysis that cuts off many lines of debate that could excuse a deficit higher than the 3% reference value. They believe the EU's political crisis has strengthened the EC's resolve to press ahead and demonstrate that the SGP has not been weakened. Finance Ministers, in this EC expert view, will be leery about challenging the EC working with the freshly minted rules. While the cases of Italy and Portugal are set to proceed, as before, the cases of German and France will demonstrate whether, in fact, there is a new political will to make the SGP function in a more robust, but economically rational, way.

¶24. (SBU) The "extra year" for deficit correction is likely to be perceived as slippage from previous recommendations. Two comments are in order. First and foremost the national political reality and the economic policy mix of the country concerned will dictate how quickly or sharply the deficit can be reduced. Withdrawing 2% of GDP can't be easy for any country and certainly was not economically healthy for Portugal. Second, the EC has sometimes been guilty of a slight of hand by not always promptly identifying a deficit as excessive, and thus defacto granting an extra year. This happened in the previous case against Portugal when the EC's recommendation slipped into January before the Council "identified" the deficit, giving Portugal an extra year for correction. The point of the SGP is to push countries in the right direction and give confidence that the government has or is getting the budget situation under control. Deadlines imposed from Brussels are less important than the substance of government's fiscal decisions that may take more time and local politicking.

¶25. (U) This report coordinated with USEU and Embassies Lisbon, Rome, Paris, Berlin and Luxembourg.

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